

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:PEN:PIT:TL-N-6886-98  
DPLeone

date:

to: John Niederst  
Manager, Group 708

from: Associate District Counsel, Pennsylvania District, Pittsburgh

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subject: [REDACTED] - Should the LIFO reserve be recaptured when a  
C corporation contributes the LIFO inventory to an LLC,  
taxed as a partnership?

This is in response to your request for an opinion regarding  
the merits of the position contained in the Form 5701 dated  
[REDACTED]. ([REDACTED], \$[REDACTED], inventory, SAIN No.  
103).

This opinion has been forwarded to the National Office of  
the Office of Chief Counsel for post-review. Accordingly, the  
opinion at this time should not be regarded as final. The  
National Office will review this opinion and there is a  
possibility that the opinion will change as a result of said  
review. The post-review time line is very short, and we will  
inform you immediately of the results of the post-review by the  
National Office.

ISSUE

Whether the reserve for the LIFO inventory contributed by  
[REDACTED] to [REDACTED]  
[REDACTED] should be recaptured by [REDACTED] in the  
[REDACTED] tax year.

ANSWER

We cannot find any theory to recapture the LIFO reserve in  
[REDACTED], even though we do agree that the particular facts in this  
case are clearly distinguishable from the scenario in Ltr. Ruling  
9644027 (July 25, 1996). Please note that we have not addressed  
herein whether the contributed LIFO inventory from [REDACTED] must be  
segregated in a separate pool by [REDACTED]. If that alternative  
position is being raised against the LLC for [REDACTED], you may wish  
to submit that position to our office for opinion.

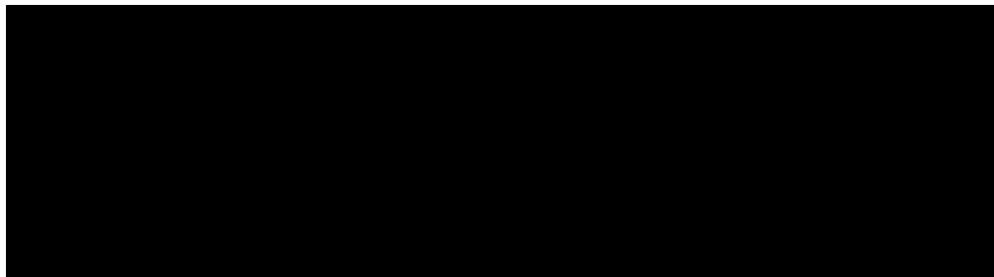
FACTS

In [REDACTED], [REDACTED] was established. [REDACTED] was a strategic agreement designed for the following objectives:

- 1) to eliminate commercial conflict of interest between owners;
- 2) to better assure a global view, and rationalization and integration of facilities, products and markets;
- 3) to diversify risks, both political and economic;
- 4) to provide a flexible structure in order to place the parties in a better position to capture growth opportunities; and
- 5) to lower transaction costs.

The business to be conducted by this worldwide enterprise included combining the current interest of the parties in [REDACTED], [REDACTED] and the [REDACTED] (" [REDACTED] ") [REDACTED] operations as well as [REDACTED]'s [REDACTED] operations and [REDACTED] operations. The parties to the [REDACTED] are as follows:

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[REDACTED] is run by the [REDACTED]. [REDACTED] is the industrial leader of [REDACTED] and provides the operating management to the [REDACTED] companies. All dealings between the [REDACTED] companies and [REDACTED] are to be on an arm's length basis. In order to implement the strategic design of the worldwide enterprise, [REDACTED] different equity or asset transfers were planned. Additionally,

- a) [REDACTED] purchased an additional [REDACTED]% of [REDACTED] of [REDACTED] from [REDACTED] for US\$ [REDACTED];
- b) [REDACTED]'s holdings in [REDACTED] increased to [REDACTED]% & [REDACTED]'s reduced to slightly under [REDACTED]%;

c) [REDACTED] acquired a [REDACTED]% interest in the rest of [REDACTED]'s [REDACTED] businesses; and

d) [REDACTED] paid US\$ [REDACTED], net of payment for [REDACTED] of [REDACTED].

As part of the implementation of the [REDACTED] [REDACTED] a limited liability company, was established. On [REDACTED], a Certificate of Limited Liability of [REDACTED] a Certificate of Formation, was filed in the State of Delaware. [REDACTED] was established by the [REDACTED] agreement, between [REDACTED] and [REDACTED]. [REDACTED] is a subsidiary of [REDACTED]. [REDACTED] is taxed as a partnership.

Under the limited liability agreement, [REDACTED] and [REDACTED] each contributed, or were deemed to have contributed, [REDACTED]% of the capital contributions, and each were given a [REDACTED]% interest in [REDACTED].

Members were not allowed to resign from [REDACTED] and could not assign or otherwise transfer in whole or in part its limited liability interest in the LLC. However, one or more additional members could be admitted to [REDACTED] with the consent of all of the members.

The Limited Liability Agreement of [REDACTED] was amended and restated as of [REDACTED], and was between [REDACTED] [REDACTED] a company incorporated in the State of [REDACTED] and [REDACTED] [REDACTED], a company organized and existing under the law as of the State of Delaware ("[REDACTED]"), as members of [REDACTED]. The initial percentage interest<sup>1</sup> and capital contributions of the members was as follows:

	<u>Percentage Interest</u>	<u>Capital Contribution</u>
[REDACTED]	[REDACTED]% [REDACTED]%	\$ [REDACTED]

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<sup>1</sup> "Percentage interest" is defined as, with respect to any member and with respect to any point in time, such member interest in the LLC equal to the ratio (expressed as a percentage) of the balance at such time in such member's capital account to the aggregate capital account balances of all members at such time, such capital accounts to be determined after giving effect to all prior contributions, distributions and allocations to all members.

██████████ ██████████% ██████████%  
It was the stated intent of the parties that the ██████████%/██████████ ratio of the respective aggregate percentage interests of ██████████ and ██████████, on one hand, and ██████████ and ██████████ on the other hand, would be maintained to the extent possible.

As part of its contribution, ██████████ contributed LIFO inventory with a market value of \$██████████, and a book value of \$██████████. Pursuant to the section 1.2(h) of the Tax Protocol, incorporated as Exhibit A to the Amended and Restated Limited Liability Agreement, a member's capital contribution means the amount of money and the Initial Gross Asset Value of any property (other than money) contributed to the LLC. Gross Asset Value, with respect to any asset, is defined generally in the Tax Protocol as the asset's adjusted basis for federal income tax purposes. However, in addition to other exceptions to the general definition, the Initial Gross Asset value is defined in section 1.2(o)(i) as the gross fair market value of such asset, as determined by appraisal or other valuation method. Accordingly, for the LIFO inventory, ██████████ would be deemed to have made a capital contribution of \$██████████, even though its tax basis in the property was only \$██████████. It is the difference between these amounts, the LIFO reserve of \$██████████, which the agent wants to recapture.

Decisions of the LLC are to be decided by affirmative vote of the majority. The representatives of ██████████ and ██████████ must vote as a unit. Certain decisions required a super-majority vote (members holding ██████████% or greater) to pass:

- a) change of scope of the LLC;
- b) change in the distribution policy of the LLC;
- c) equity requests to the members on behalf of the LLC totaling in any one year more than US\$██████████;
- d) sale of all or a majority of the assets of the LLC (such assets to be valued for this purpose of determining whether a majority of the assets will be sold at the LLC book value);
- e) loans to ██████████ or ██████████ or their affiliates by the LLC (whether directly or indirectly) or any one of its affiliates; and
- f) change the number of representatives on the board of

representatives of the LLC from [REDACTED].

Although [REDACTED] has a [REDACTED] share in the LLC, it is not in control of the LLC.

Under the amended and restated limited liability agreement, transfers could be made to new members. However, the permissible conditions for the transfer were limited to certain percentages, and the transfers in some instances required consent of the other members or the expiration of a purchase-option which had to be made to the other members.

Under the amended and restated agreement, [REDACTED] would dissolve upon the first to occur of the following events: a) written consent of the members, b) the death, retirement, resignation, expulsion, bankruptcy or dissolution of a member or the occurrence of any other event which terminates the continued membership of a member in [REDACTED], unless within [REDACTED] days all of the remaining members agree to continue and to the appointment, if necessary or desired, of one or more additional members, effective the date of the occurrence; c) the entry of a decree of judicial dissolution under the state act; or d) the sale of all or substantially all of the property.

Upon dissolution, the LLC's business is to be wound up and liquidated as rapidly as business circumstances allowed. The amended and restated agreement provided the method by which fair market value was to be determined upon dissolution and liquidation. For a period of [REDACTED] days, the value was to be negotiated. Upon election by any member, an appraisal of the assets of the LLC would be performed by a recognized appraisal firm (accepted by all members). If the parties cannot agree on a firm within [REDACTED] days, then [REDACTED] together with [REDACTED] and [REDACTED] together with [REDACTED] shall each select an appraisal firm and secure appraisals. If the appraisals do not agree, the fair market value shall be the mid point between the two valuations.

The reserve for the LIFO inventory contributed by [REDACTED] to [REDACTED] was built-up over almost a [REDACTED] year period. The cost index is based upon [REDACTED] costs.

For the tax year ended December 31, [REDACTED], [REDACTED] filed a Form 970, Application to Use LIFO Inventory Method, carrying forward the prior year LIFO reserve.<sup>2</sup> Further, [REDACTED] is treating all of its inventory in one pool, the contributed inventory and the acquired inventory. As a result, [REDACTED]

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<sup>2</sup> There is some discrepancies in the calculation, but generally speaking the LIFO reserve is continued.

determined an increase to the reserve of \$ [REDACTED] for [REDACTED].

Please note that it is not anticipated that any of the LIFO layers of the contributed inventory would be invaded if [REDACTED] is permitted to maintain one pool consisting of both the contributed inventory and the newly acquired inventory. Accordingly, if the reserve is not recaptured, it is unlikely that any of the \$ [REDACTED] LIFO reserve will be recaptured. [REDACTED] will have effectively exchanged its interest in the LIFO inventory for an interest in a LLC that it does not control and will not realize any tax consequences.

The agent agrees with [REDACTED]'s contentions that the LLC is to be taxed as a partnership for federal tax purposes.

#### DISCUSSION

The revenue agent argues that [REDACTED] should recapture the LIFO inventory because it should be deemed to have, in effect, sold the inventory. The inventory now belongs to the partnership, an entity in which [REDACTED] only has a [REDACTED] percent interest. The percentage partnership interest which [REDACTED] acquired was based upon the fair market value of the property, so [REDACTED] received value for the inventory without realizing gain. Moreover, due to the nature of LIFO accounting, [REDACTED] may never have to recapture the reserve because the layers may never be invaded. As a result, [REDACTED] receives value commensurate with the fair market value of the inventory, transfers the inventory to an entity that [REDACTED] does not control, yet [REDACTED] may never have to realize the gain by recapturing the reserve.

I.R.C. § 721(a) provides that neither a partnership nor any of its partners recognizes a gain or loss when property is contributed to a partnership in exchange for a partnership interest. Section 721(a) precludes recapture of the reserve since the recapture would result in a recognition of gain from [REDACTED]'s contribution of the inventory.

In LTR 9644027 (July 25, 1996), a subchapter S corporation owned and operated separate motor vehicle dealerships under four franchise agreements. The sole shareholder of the subchapter S corporation was a trust, having received the interest by inheritance when the former sole shareholder died.

Each dealership is operated as a separate division and separate accounting records are maintained for each division. The subchapter S uses the link-chain LIFO method of valuing its inventories, with three LIFO pools: 1) new trucks and

demonstrators; 2) new cars and demonstrators; and 3) new parts. Items are not distinguished within each pool by model or make of vehicle. An outside index is used to the aggregate dollar value of each pool to determine the LIFO value and the LIFO reserve amount for each pool.

Manufacturers of the vehicles insisted that the general managers be allowed to acquire an "incentive" ownership interest in the dealerships they manage. One manufacturer required the subchapter S to provide the general manager to acquire such an interest as a condition of the franchise agreement.

The facts in [REDACTED] are distinguishable from those in LTR 9644027. Unlike the subchapter S corporation in LTR 9644027, [REDACTED] no longer had control over the assets once the LLC was formed, and the other partners of [REDACTED] are not employees of [REDACTED], nor are controlled by [REDACTED]. However, these distinctions do not provide a reason to reject the conclusion that section 721 allows the contribution of LIFO inventory to [REDACTED] without triggering a recapture of the LIFO reserve.

I.R.C. § 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Treas. Reg. § 1.704-3(a)(1). Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.

It is our understanding that the revenue agent has reviewed the section 704(c) allocations by the [REDACTED] and has accepted said allocations. [REDACTED] argues that, since the provisions of section 704(c) provide the means to avoid shifting tax consequences to other partners, that provision ensures that [REDACTED] will eventually be responsible for the built-in gain on the contributed inventory.

Although section 704(c) should prevent a shifting of the tax consequences, it does not address the fact that the gain on the inventory continues to be deferred indefinitely, without recognition, even though [REDACTED] no longer has control over the inventory. This is not that significant when other assets are considered, since there normally would be tax consequences which

would be readily realized by the partnership, and then would affect the distributive share of the contributing partner. However, since it is anticipated that the contributed LIFO inventory will continuously add new increments or layers, there is no reason to believe that [REDACTED] will have to realize the built-in gain on the inventory in the foreseeable future.<sup>3</sup> Nevertheless, the nature of property contributed, LIFO inventory, is not enough to avoid the conclusion that section 721(a) requires a continuation of the reserve in the LLC.

Please call Donna Leone at 412-644-3442 if you have any questions.

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EDWARD F. PEDUZZI, JR.

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<sup>3</sup> Compare I.R.C. § 1363(d), which provides for a recapture of LIFO benefits when a C corporation becomes an S corporation, with additional tax payable in four installments.